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AUTHOR	Liebschutz, David S.; Schieder, Jeffrey S.; Boyd, Donald J.
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ABSTRACT

This report summarizes the status of states' budgets at the end of fiscal year 1997. The year's strong national economy boosted tax revenues and helped to decrease welfare rolls. Unemployment at the end of 1997 was below 5 percent nationally and real GDP growth was 3.5 percent for the first 3 quarters of the year. These indicators translate into good news for states as most of them realized surpluses at the end of fiscal year 1997 and higher-than-expected revenues at the beginning of fiscal year 1998. In light of the strong economy, most states cut taxes; however, Hawaii did not finish the year in strong financial condition. Overall, 34 states decreased taxes and 14 states increased taxes during 1997 legislative sessions. Most of the tax cuts tended to be relatively small and are scheduled to be phased in over several years. The personal income tax was the most popular tax to cut, with 22 states doing so. A combination of continued optimism in the economy, revenue collections exceeding expectations, and election-year politics may result in even more tax cuts in 1998. The report also speculates as to state budgets and finance for 1998. Two tables are included. (Contains 19 endnotes). (LMI)

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STATE FISCAL BRIEF

Center for the Study of the States
Nelson A. Rockefeller Institute of Government

December 1997
No. 45

FY 1997 Year End Budget Summary

DAVID S. LIEBSCHUTZ, JEFFREY S. SCHIEDER & DONALD J. BOYD

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HIGHLIGHTS

- Every state, except Hawaii, finished FY1997 in strong financial condition.
- Overall, 34 states decreased taxes and 14 increased taxes during 1997 legislative sessions.
- Although there were a few major tax cuts, tax cuts tended to be relatively small and scheduled to phase in over several years.
- The personal income tax was the most popular tax to cut, with 22 states cutting it.
- A combination of continued optimism in the economy, revenue collections exceeding expectations, and election year politics may result in even more tax cuts in 1998.

INTRODUCTION AND SUMMARY

The national economy continues to grow strongly. Unemployment is below 5% nationally, and real GDP growth was 3.5% for the first three quarters of 1997. States underestimated the strength of their economies when they developed their FY1997 budgets.[1] The strong national economy boosted tax revenues, mostly in personal and corporate income taxes, and helped decrease welfare rolls. These indicators translate into nothing but good news for states as most states realized surpluses at the end of FY1997 and higher than expected revenues at the beginning of FY1998.[2]

The only state not enjoying the fiscal good times is Hawaii.[3] Hawaii ended FY1997 with a $20 million deficit and projects an additional $275 million deficit for its 1997-99 biennium.

In light of the strong economy and surpluses, most states cut taxes. Overall, 34 states cut taxes this year, while only 14 increased taxes. Most of the tax cuts were moderate compared to the size of the state's budget, but a few were significant. The biggest of these cuts were back-loaded with most of the revenue loss occurring after 1998.[4]

Some states, such as North Carolina and Pennsylvania, used their surpluses to add to their "rainy day" or contingency funds. Other states, such as California and Louisiana, used their surpluses to pay off debts and other obligations.

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TAX ACTIONS

Tax Cuts

Overall, 34 states cut taxes this year (see Table 1). Personal income taxes proved to be the most popular tax to cut this legislative session. Twenty-two states cut personal income taxes, while nine cut property taxes, nine cut corporate taxes, and 10 cut sales taxes.[5] Some of these cuts are actually state mandated cuts in local taxes where lost revenue to localities will be replaced by increased state aid. Property tax cuts in Kansas, New York, Oregon, and Texas, detailed below, are such cuts.

Most of the tax cuts were passed before states finished tallying income tax revenue from April's tax returns, which was exceptionally strong in many states, and so many states did not realize the extent of their good fiscal fortunes at the time. Most cuts are designed to be phased in over a number of years.

Personal Income Tax

Of the 22 states that cut personal income taxes this year, 10 states cut rates, six increased exemptions, 11 increased deductions or credits, and three states had mandated refunds.[6] Three states, Indiana, Massachusetts, and Oregon, enacted earned income tax credits or deductions.[7]

Although personal income taxes were widespread, most cuts were not very large, and most will take effect over the next several years. Some of the largest tax cuts affecting tax year 1997 are really one-time refunds caused by states having collected more revenue in FY1997 than they are legally permitted to keep.[8] Ohio, for the second year in a row, will refund excess tax revenue to taxpayers. This year's refund will total $263 million, taken as about a 4% rate cut. Colorado will refund $142 million to taxpayers in the form of a "sales" tax credit (to avoid having the refund considered taxable income under the federal Internal Revenue Code) claimed on the income tax return. Oregon taxpayers will receive a 14% rebate of their 1996 personal income tax liabilities, totaling $431 million.

One state that did make a significant recurring cut in its income tax was California. As part of a deal between legislators and Governor Pete Wilson (R), California passed a tax cut package that will cost the state about $1.7 billion over the next three years. It will increase the dependent credit $150 in two steps over the next two years. The credit increase will represent two-thirds of the cost of the tax package at full implementation in 1999-2000 and will cost the state $95 million in FY1998, $400 million in FY1999, and $635 million per year when fully implemented. The tax cut package also increases the exemption level of the alternative minimum tax (AMT) and indexes the exemption to the federal consumer price index (CPI). The exemption increase is expected to cost the state $8 million in FY1998, $81 million in FY1999, and $85 million in FY2000.

Other tax actions, including four federal conformity measures, will also affect state revenues significantly. These measures conform California's tax code to the federal code on capital gains changes for home sales, IRA changes, S Corporation changes, and research and development credit changes.[9] Together, these conformity measures will cost the state an estimated $92 million in FY1998, $192 million in FY1999, and $123 million in FY2000. The individual retirement account (IRA) provisions will prove more important in out-years, as the lost revenue to the state rises considerably over time, from only $4 million in FY1998 to an estimated $185 million in FY2003.

Arizona lowered income tax rates for all taxpayers and increased exemptions by $2,100 for married couples filing jointly with at least one dependent. This will cost the state about $110 million annually. Iowa enacted a 10% across-the-board rate cut in its personal income tax, effective January 1, which will cost the state about $103 million in FY 1998 and $200 million annually after that. Massachusetts increased exemptions by 18%, enacted an EITC at 10% of the federal credit, and doubled the dependent child deduction (from $600 to $1,200 per family) for families with children under 12. After a gubernatorial veto and a special session, Minnesota enacted $80 million in education tax credits and deductions, effective in tax year 1998. Maryland passed a 10% income tax cut (dropping the top rate from 5% to 4.75%) and an increase in the personal exemption from $1,200 to $2,400, that will be phased in over the next five years.

Property Taxes

Nine states enacted property tax cuts this year. A distinction must be made here between a cut in the state property tax and a state mandated cut in local property taxes (whether financed by the state or not). A cut in the state property tax reduces state revenue. A state mandated cut in local property taxes will reduce local revenue and the state may or may not replace the revenue localities lose with increases in state aid to localities. Vermont, discussed in the Tax Increases section, does not fall in the same category as states that mandated reductions in local property taxes and will replace the lost local revenue with state money. Vermont will levy a new state school property tax and provide districts with a statewide education block grant.[10] Localities will have the option of spending above the state block grant where their local property tax rate will be determined by an equalized per-student formula.

A state mandated cut in local school property taxes can have a large effect on school district funding as most of local spending on K-12 public education is funded through school property taxes. For districts to be held harmless, the state must replace the lost local property tax revenue with increased state spending. This then shifts funding responsibility for public education from localities to the state. Thus, a state mandated cut in local property taxes often translates into an increase in state expenditures. This is the case in eight of the nine property tax cutting states. Only Washington cut state property taxes.

Five of the nine states' property tax cuts were over $100M in relief. Four of these five significant cuts are state mandated cuts in local property taxes. In New York,

TABLE 1
TAX CHANGES ENACTED IN 1997

State	PIT	Business	Sales	Property	Other	Comments
Arizona	x					Changes rates and increases exemption $2100 for married couples filing jointly with one dependent ($110M)
Arkansas	x					$70M in PIT deductions and credits if sales tax on food not enacted
California	x					Increases tax deductions for dependents, federal conformity changes; total cost $166M in FY98, $863M in FY99, $931M in FY00
Colorado	x					$140M one-time refund
Connecticut	x			x	x	$126M PIT cut over 2 years; 6 cent/gallon gas tax cut over 2 years
Delaware					x	Gift tax cut; increases inheritance tax threshold
Florida					x	One year $162 million decrease in unemployment insurance tax
Hawaii					x	Movie and TV producer tax breaks
Indiana	x			x		Earned Income Tax Deduction; PIT child deduction; 6% homestead credit rate increase over 4 years
Iowa	x	x	x			10% PIT rate cut ($103M in FY98)
Kansas	x			x		Property tax mill rate decreased 6 mills; first $20,000 of assessed value removed from PT levy ($233M over 2 years)
Louisiana	x		x		x	Did not renew additional 1% food sales tax ($110M/year)
Maine	x					$50 increase in PIT exemption ($3M/yr)
Maryland	x					5 year PIT rate cut; increase personal exemption
Massachusetts	x		x			EITC; doubled dependent child credit; increased exemptions
Michigan	x					$5000 per child child care credit; 8% tuition tax credit
Minnesota	x	x	x	x		$500M in onetime and $265M in ongoing PT relief; $80M in education credits
Missouri			x			Food sales tax reduction
Montana	x					Family savings accounts exempt
Nebraska	x				x	$127M over 2 years PIT rate cut
Nevada					x	Aviation fuel tax cut
New York	x	x	x	x	x	$2.3B 4 year PT reform; Gross Receipts Tax on utilities cut over 3 years; repeals sales tax on clothing under $100
North Carolina			x			Decreases state wide sales tax on food from 3% to 2%, cost $38M in FY98, $89M in FY99
Ohio	x	x				$263M PIT refund (one-time)
Oregon	x	x		x		Non-refundable EITC; $870M/2 years PT relief, PIT and CIT refunds
Pennsylvania		x	x			$165M in business and sales tax cuts
Rhode Island	x	x				PIT rate cut over 5 years ($56M/5 years)
Tennessee		x				Insurance excise taxes phased out by 2002
Texas				x		Increases homestead credit from $5,000 to $15,000 ($1B/2 years)
Utah			x		x	Sales and use rate decrease ($34M)
Virginia					x	Unemployment insurance tax decreased
Washington		x	x	x	x	Decrease in Business and Occupation tax rates; 4.7% PT cut
West Virginia	x			x		Phaseout of intangible PT
Wisconsin	x					1% PIT rate cut for CY1998 ($50M in FY99); increase in marriage credit; new working family tax credit
# of states:	22	9	10	9	12	

the four-year $2.3 billion school property tax relief program (STAR), effective in the 1998-99 school year, was the cornerstone of the state's sweeping tax cut package enacted this year.[11] When fully phased in, senior homeowners will receive a $50,000 homestead exemption and homeowners under 65 will receive a $30,000 homestead exemption. With the state fully reimbursing school districts for lost property tax revenue from these exemptions, the state share of K-12 education is expected to increase from about 38% to 44%. However, because most of this relief is back-loaded, New York property taxpayers will not realize any relief in FY1998 and only an estimated $116 million in FY1999. Because the state will reimburse districts on a dollar-for-dollar basis, the program will not alter the degree of spending inequality in the state.

Texas voters overwhelmingly approved property tax relief in the form of a permanent increase in the school district property tax homestead exemption from $5,000 to $15,000, effective September 1, 1997. Governor George Bush (R) has stated that property tax relief for the FY1998-99 biennium will by funded by a $1 billion budget surplus from the prior biennium; however, there is no guarantee that the state will continue to make up for the lost local revenue from the homestead exemption increase.

In May, Oregon voters passed Measure 50, which reduces and caps assessed values of property and will cost approximately $800 million over two years. Measure 50 replaces Measure 47, which would have reduced and limited property tax rates but was found too difficult to implement. The measure mandates that the state make up the lost funds to school districts, but not to other local governments.

Kansas will decrease its statewide local school property tax mill rate from 33 to 27 and remove the first $20,000 of assessed value for all residential property from the levy for the next two school years, resulting in a $235 million savings for homeowners. The state will make up for the lost local revenues in increased state aid to schools.

Earlier this year, Washington Governor Gary Locke (D) signed a measure that will extend a 4.7% state property tax cut, originally passed in 1995 for tax year 1996, for tax year 1997. In addition, on November 4, voters passed by more than 63% a property tax relief ballot measure that state lawmakers placed onto the state's general election ballot. The ballot measure, Referendum Bill 47, will limit annual local property tax increases allowable without voter approval, spread large valuation increases for individual properties across several years, and makes the 4.7% state levy reduction permanent. Washington's Department of Revenue projects that the ballot measure will reduce state tax revenue by $195 million for the 1997-99 biennium and $426 million in 1999-2001. The reduction in local government property taxes is projected to be $108 million for 1997-99 and $313 million for 1999-2001.[12]

Property tax relief in Minnesota came in the form of a $500 million one-time rebate for homeowners and renters and $258 million in ongoing relief for virtually all property classes. The rebate will equal 20% of property taxes paid in 1997 and will be allowed as a refundable income tax credit for tax year 1997. The ongoing relief includes a reduction in rates for several property classes and an education homestead credit equal to 32% of the property's general education tax. After this tax cut was enacted, when Minnesota's final FY1997 revenues came in more than $300 million above projections, lawmakers and Governor Arne Carlson (IR) began calling for even more tax relief. Tax cutting will be on Minnesota's agenda next year.

Business Taxes

Nine states cut business taxes this year. For the second biennium in a row, Oregon corporations, in addition to individuals, will receive income tax refunds as a result of tax receipts exceeding constitutional limits. Corporations will receive a total credit of $203 million against their 1997 tax liability. This translates into about a 42% credit.

Washington State will cut the rates of each of the three service business and occupation (B & O) tax classifications (financial services, selected business services, and all other services) to 1.5%, which will reduce these rates to pre-1993 levels. The cuts do not take effect until FY1999 and will cost the state $94 million in the current 1997-99 biennium and $239 million in the FY1999-2001 biennium.

Minnesota will cut its health care provider tax from 2% to 1.5% for calendar years 1998 and 1999 (and the lower rate will be extended into 2000 and 2001 if the finance commissioner determines a "positive structural balance" for the state's health care access fund for FY2001) at an annual cost of $60 million.

New York will decrease the gross receipts tax on energy utilities and telecommunications companies from 3.5% to 2.5% in two steps by 2000. Once fully implemented, this will cost the state about $440 million per year. Like the STAR property tax cut, this tax cut is heavily back-loaded, providing no relief in FY1998 and only $28 million in tax relief in FY1999.

Sales Tax

Of the ten states that cut their sales tax this year, only Utah decreased the general sales tax rate. Utah decreased their sales tax rate from 4.875% to 4.75% at a cost of $34 million per year. All the other states' cuts in the sales tax were targeted to specific goods or services. Three states cut their sales tax on food, New York repealed its sales tax on clothing under $100, and Massachusetts repealed its sales tax on Internet services until 1999. The remaining four states enacted miscellaneous sales tax cuts.

Louisiana, Missouri, and North Carolina all cut their sales taxes on food due to their strong revenue growth. Louisiana opted not to renew a 1% "temporary" rate increase on their food and utilities sales tax. The 1% additional tax had been consistently renewed since it was instituted over a decade ago. The tax will fall back to 3% and result in lost revenue of $110 million annually. Missouri lawmakers decided to enact Governor Mel Carnahan's (D) call for a decrease in the state's sales tax on food from 4.225% to 1.225%. The tax cut is estimated to reduce state revenue by $158 million in FY1998. Revenue from the new 1.225% rate will be deposited into

an education trust fund. North Carolina will decrease its statewide sales tax on food from 3% to 2%.

Due to the state's large budget surplus of over $500 million, Pennsylvania Governor Tom Ridge (R) was able to cut the sales tax by $165 million through various exemptions that generally benefited businesses. The largest tax cut came from exempting computer services from the state's 6% sales tax, at an estimated cost of $79 million annually.

Miscellaneous Tax Cuts

In addition to the cuts in the four main taxes (personal income, business, property, sales) states also enacted cuts or increases to many other taxes. Like the major tax cuts, most of these miscellaneous cuts are relatively small.

They include cuts in unemployment compensation taxes (Florida, North Carolina, Utah, and Virginia), the profit tax (Delaware, New York), and the estate tax (Delaware, Louisiana, New York, North Carolina).

Tax Increases

Of the 14 states that increased taxes this year, only Vermont enacted broad-based tax increases; the remaining 13 state tax increases consisted of cigarette and fuel rate increases, motor vehicle fee increases, and other small or miscellaneous increases.

In response to a state supreme court decision in February that declared its school finance system unconstitutional, Vermont established a statewide school property tax of $1.10 per $100 of assessed value, allowed local option sales, meals and rooms, and alcohol taxes for three years beginning in 1999; and increased other state taxes by $58 million. These tax increases include a 4 cent per gallon gas tax increase, a 2% rate increase in the meals and room tax, a 1.5% corporate income tax rate increase, a new 4.36% telecommunications service tax, and a 1% rate increase on the sales tax on automobiles, boats, and campers. However, Vermont taxpayers will see a slight decrease in taxes on balance, as their local property taxes will be decreased. School property tax rates will now be based upon a complex equalized yield system where a district's school tax rates, if the district opts to spend above the state block grant amount, are determined by local decisions on the amount they want to spend per student.

The remaining state tax increases include seven cigarette rate increases (Alaska, Hawaii, Maine, New Hampshire, Rhode Island, Utah, and Wisconsin), five fuel tax increases (Michigan, Pennsylvania, South Dakota, Utah, and Vermont), and four motor vehicle charge or fee increases (California, Michigan, Pennsylvania, and Utah).

Other than Vermont, all of the states that raised their motor fuel tax will dedicate the additional revenue to highway spending. The largest of these actions is Pennsylvania's $404 million a year gas tax and motor vehicle fee increase, which will fund highway repairs and maintenance. Alaska dedicated its cigarette tax increase to a school construction fund, and Maine dedicated its increase to a tobacco tax relief fund.

Tax Proposals that Failed

As always, there were a number of tax proposals, both increases and cuts, that failed this year. The proposals ranged from business tax cuts to sales tax rate increases. The reasons for failure of the proposals ranged from a dearth of legislative support to a governor's veto to a court decision.

In Florida, Governor Lawton Chiles (D) vetoed $27 million in business tax breaks that would have benefited such companies as Pan Am and General Motors. In his veto message the governor stated that the legislation was hastily passed without appropriate legislative consideration, could not be defended on economic development grounds (the basis on which supporters touted the legislation), and provided too many narrowly targeted tax breaks. This is the second year in a row that Chiles vetoed legislation providing businesses with tax breaks.[13]

In Illinois, Governor Jim Edgar (R) did not convince his own party to accept a personal income tax increase to finance higher state spending for schools and relieve funding pressures on localities. This is the second year in a row that the governor did not push school finance reform through the legislature. Also, the governor vetoed a number of tax measures, including a bill that would have changed the state's three-factor corporate income tax formula to a single-sales factor.

School finance reform also failed in Ohio as a $1 billion sales tax plan died in the legislature. The proposal to raise the state's sales tax from 5% to 6% was felled by a "no new taxes" pledge from House conservatives. The state has until March 1998 to reform the property tax reliant school finance system declared unconstitutional by the state's supreme court.

In Texas, the governor's proposals for an increased sales tax and a new business tax to finance $3 billion in local property tax relief died in the legislature. However, the governor was able to claim victory when voters passed a $1 billion property tax relief plan in an August referendum.

Finally, in late August, the Arizona Supreme Court upheld a superior court decision that declared the $32 million capital finance reform plan, Assistance to Build Classrooms (ABC), signed by former Governor Fife Symington (R) in April, failed to satisfy the state supreme court's 1994 mandate for the state to provide equal educational opportunities to students.[14] If an acceptable capital finance plan is not in place by June 30, 1998, the court could freeze all state funding to public schools.

BUDGET ACTIONS

Surpluses

Almost all of the states ended FY1997 with surpluses. As Table 2 shows, states' FY 1997 year end balances averaged 7.3% of total general fund expenditures. According to the National Conference of State Legislatures, this is the healthiest states have been since FY 1980.[15] Three main interrelated factors contributed heavily to state surpluses.

TABLE 2
STATE YEAR-END BALANCES AS A PERCENTAGE OF GENERAL FUND EXPENDITURES, FY1997
(Includes budget stabilization funds)

State	Amount (millions)	% of GF Expenditures	Rank
United States	**$28,235**	**7.3%**	
New England			
Connecticut	503	5.5	27
Maine	61	3.4	36
Massachusetts	1,159	6.5	23
New Hampshire	9	1.1	47
Rhode Island	92	5.2	29
Vermont	45	6.3	24
Mid-Atlantic			
Delaware	210	11.9	13
Maryland	633	8.6	18
New Jersey	1,078	6.8	22
New York	749	2.4	44
Pennsylvania	624	3.8	33
Great Lakes			
Illinois	806	4.8	31
Indiana	1,546	19.6	2
Michigan	1,262	15.2	5
Ohio	1,665	12.4	10
Wisconsin	330	3.7	35
Plains			
Iowa	430	10.4	15
Kansas	462	13.0	8
Minnesota	1,610	16.7	3
Missouri	339	5.4	28
Nebraska	232	12.3	11
North Dakota	65	9.2	17
South Dakota	24	3.8	33
Southeast			
Alabama	32	0.7	48
Arkansas	46	1.6	46
Florida	1,182	7.6	21
Georgia	315	2.9	39
Kentucky	452	8.0	20
Louisiana	0	0.0	49
Mississippi	276	9.9	16
North Carolina	1,261	12.1	12
South Carolina	296	6.2	26
Tennessee	120	2.1	45
Virginia	414	5.1	30
West Virginia	71	2.9	39
Southwest			
Arizona	753	15.3	4
New Mexico	187	6.3	24
Oklahoma	520	12.6	9
Texas	1,919	8.5	19
Rocky Mountain			
Colorado	473	11.0	14
Idaho	42	3.1	38
Montana	24	2.5	43
Utah	100	3.3	37
Wyoming	0	0.0	49
Far West			
Alaska	3,202	132.4	1
California	1,267	2.6	42
Hawaii	93	2.9	39
Nevada	204	13.2	7
Oregon	628	15.1	6
Washington	406	4.3	32

Source: Corina Eckl and Arturo Perez. *State Budget Actions*, 1997 (NCSL: Denver).

The first is the strong growth in the national economy. GDP growth for the first nine months of 1997 was estimated by the U.S. Commerce Department to be 3.5%.

The unemployment rate is below 5%, the lowest it has been in almost 25 years. A strong economy produces two beneficial results for governments, a boost in tax revenue, particularly personal and corporate income revenue, and slower growth, or even decreases, in welfare and Medicaid caseloads. Thus, the strong economy has simultaneously yielded greater than expected revenues and less than expected spending.

The second factor is the strong performance of the stock market. Nothwithstanding its recent decline the market has still experienced double-digit gains for the year which translates into more tax revenues flowing into state coffers through increased taxes on capital gains and various forms of compensation linked to stock performance.

The third factor is that many states started the fiscal year with conservative estimates for revenue growth. These estimates often are exceeded in a strong economy. Since revenue continued to exceed projections even after most states enacted their FY1998 budgets, continued surpluses are likely in many states in FY1998 as well.

Hawaii is the only state experiencing economic hard times. Unlike the other 49 states, Hawaii's economy is tied to and affected more by the Japanese economy, which has not performed as well as the U.S. economy in recent years, than by the US economy. Caught in a recession it cannot shake, Hawaii ran a deficit of $20 million in FY1997. The expected budget shortfall for the current FY1997-99 biennium is approximately $275 million.

Other State Responses to Surpluses

In addition to tax cuts (mentioned above), budget surpluses have also been used to bolster "rainy day" or contingency funds or to pay for additional spending projects.

Pennsylvania, for example, had a budget surplus of $500 million. One hundred sixty five million dollars of this surplus went to tax cuts, mainly for businesses, and another $179 million was added to the state's rainy day fund. Connecticut used its $263 million FY1997 surplus to pay off the last of the state's debt that it incurred after its budget crisis in 1991 ($167 million) and put the rest of the surplus into its rainy day fund ($96 million). North Carolina, in addition to cutting taxes by $80 million and giving state teachers a 6.5% pay raise, added $500 million to a state contingency fund.

Other states have used their surpluses to pay off debts or to pay for programs favored by the state's governor or legislature. Louisiana was able to cut $110 million in taxes and allocate $360 million to pay off the state's bonded debt, and still had $146 million left over for increased spending in FY1998. Delaware lawmakers reached agreement with Governor Thomas Carper (D) to use $14 million of the state's $108 million FY1997 surplus to cut taxes and target the remainder to fund public works projects favored by the governor. California Governor Pete Wilson used much of

the state's surplus to repay $1.36 billion to the state's public employee retirement system (see below).

Late Budgets

With strong economic growth and tax revenues, one would expect that state budgets would pass easily through their respective legislatures as few difficult choices about spending cuts or tax increases have to be made. Although this was the case in almost all the states, four states -- California, New York, North Carolina, and Wisconsin -- were at least a month late passing their respective budgets.

New York failed to pass its budget on time for the thirteenth straight year. Passed by the legislature and signed by the governor in early August, the budget was over four months late, a total of 128 days, the latest budget ever.[16] A late budget has become commonplace and almost expected in New York. The budget originally became held up as lawmakers and the governor concentrated on the debate over New York City rent control regulations. Later, disagreements between lawmakers and the governor over revenue estimates and the exact content of tax cuts resulted in the latest budget in state history.

California registered its second latest budget in state history when it passed its budget in mid-August, a month and a half after the start of its fiscal year. Disagreements over how to spend the state's budget surplus between the governor, who wanted $1 billion in tax relief, and Democratic lawmakers, who wanted welfare reform and pay raises for state employees, were made moot when lawmakers agreed to the governor's proposal to repay $1.36 billion to the state's retirement system in one lump sum (instead of making the payment over several years). In order to repay this amount in the budget year, legislators had to quickly shift gears to decide what to cut from the budget.

The final budget passed only after a compromise to work on a testing program for grade 2-12 students and without both the governor's tax relief and the Democrats' spending increases. Wilson then vetoed $314 million, $203 million of which was for education, and stated that he would restore the $203 million in education funding when the legislature adopts a testing program he endorses, which it did in September. Nevertheless, both sides drew some consolation from the compromise reached at the end of the legislative session, which included a tax relief program, an increased allocation to counties, expansion of child health care coverage, and a compensation raise for employees.

The North Carolina budget, like New York and California's, was held up by disagreements over welfare reform, taxes, and the appropriate level of state spending. The budget passed nearly two months late with $80 million in tax cuts and a 6.5% pay raise for teachers.

Wisconsin's budget was finally signed by Governor Tommy Thompson (R) in mid October, nearly four months after the beginning of its fiscal year on July 1. The impasse in Wisconsin was caused less by politics than by personal animosities in the senate.[17] The budget passed with personal income tax cuts (including a 1% rate cut for calendar year 1998, an increase in the state's marriage credit over four years, and a new working family tax credit), a 15 cent-per-pack cigarette tax increase, and miscellaneous personal income and sales tax increases and revenue enhancements.

Other Actions Affecting Budgets

There were two states where budget-related fiscal actions may have a significant impact on the state's future budgets.

New Jersey borrowed $2.8 billion in taxable bonds to implement a complex refinancing of the state's pension liabilities. The refinancing resulted in approximately $600 million in one-time revenue that was used to fund a court ordered supplemental funding for 28 urban school districts ($246 million) and to plug other budget holes. The state will invest its pension funds in the stock market in the hope of realizing a rate of return greater than the 7.5% interest rate at which the state borrowed.

President Clinton's use of the line-item veto of a Medicaid provision will have a negative impact on New York, if it holds up. The vetoed provision would have allowed New York to continue to use certain types of health care provider taxes restricted by Congress in 1991 as part of the state's Medicaid spending to garner federal Medicaid revenue. The provision did not provide the same benefit to any of the other 14 states with similar provider tax disputes. The Medicaid veto may end up being a test case for the constitutionality of the presidential line item veto.

What to Expect Next Year

Revenue collections have continued to exceed expectations in many states even after FY1998 budgets were enacted, spurred by strong economic growth and stock markets that, despite an October dip, remain well above last years levels. If the economy continues to perform well, many states could realize surpluses again for FY1998.

If so, we can expect to see more tax cuts as legislatures reconvene in the new year. The temptation for cutting taxes in 1998 will be especially attractive for governors and state lawmakers in a year where over two-thirds of governors and over three-quarters of all legislative seats will be up for election. Some early candidates for tax cuts include Kansas, Maine, Minnesota, and Massachusetts. In Massachusetts, acting governor Paul Cellucci (R) has already proposed to cut the state income tax from 5.9% to 5% over three years.[18]

Other states may have to make more austere budget decisions if not next year, then perhaps in later years. Hawaii, in the midst of a recession, will most likely have to institute a combination of spending cuts and tax increases to balance its budget. New York, according to the state's Comptroller H. Carl McCall (D), risks potential fiscal problems in the next few years due its heavily back-loaded tax relief and continued reliance on debt.[19]

Finally, a few states will have to deal with court mandates to reform their school finance systems. Alabama, Arizona, Ohio, West Virginia, and Wyoming all need to devise new school finance plans. Illinois, although not under a court mandate, will likely also attempt once again to reform its school finance system.

Technical Notes

The information and data contained in this Fiscal Brief was derived from information provided by state officials, state reports and documents, State Tax Notes, State Policy Reports, State Budget and Tax News, and the Bureau of National Affairs' Daily Tax Report. Details of state tax actions listed in this Fiscal Brief may differ slightly from the tax actions section listed in State Revenue Report #29 due to updated information.

About the Authors and the Center for the Study of the States

Donald J. Boyd is the director of the Center. David S. Liebschutz is the associate director of the Center. Jeffrey S. Schieder is a research assistant at the Center. The Center is part of the Nelson A. Rockefeller Institute of Government, the public policy research arm of the State University of New York. Established in May 1990, the Center is a leading authority on developments in state finances and programs. Research for this report was funded by a grant from the Ford Foundation. The Center is located at 411 State Street, Albany, New York 12203-1003, phone (518) 443-5285, fax (518) 443-5274, e-mail: santosr@rockinst.org. For further information on this or other Center reports, contact the Center's administrative assistant, Rosann Santos.

Announcements

The Steven D. Gold Award

The Center for the Study of the States would like to congratulate the winner of the First Annual Steven D. Gold Award, John Shannon, the former director of the Advisory Council on Intergovernmental Relations. The award was sponsored by the Association of Public Policy and Management, the National Conference of State Legislatures, and the National Tax Association and is awarded to a person who has made a significant contribution to the study of public finance.

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ENDNOTES

1. For further information about this, see *State Fiscal Brief #42* ("State Budgetary Assumptions for 1997 and 1998: States Predict Continued Moderate Growth")
2. Since some states account their finances on a cash basis and other states account on a modified accrual basis, the definition of a surplus may vary from state to state. Here, a surplus is broadly described as any excess cash. This excess may derive from revenue exceeding prior estimates, underspending, and/or carryover balances. (Definition borrowed from: *Budget Footnotes*, Ohio Legislative Budget Office, August 1997.)
3. Alaska and Wyoming are also performing relatively poorly. However, since both states are extremely dependent on the performance of their oil and mineral industries, these states' economic performance cannot really be compared with other states.
4. A back-loaded tax cut is a cut that is structured so that most of the tax's relief occurs in out years – that is, not in the current fiscal year(s). Since a current legislature cannot be bound by spending actions enacted by a prior legislature, back-loaded tax cuts will not necessarily be fully implemented. A legislature has three options to deal with such a tax cut passed by a prior legislature: (1) repeal the cut; (2) raise other taxes, fees, or tap other revenue sources to pay for the cut; or (3) reduce spending.
5. The sum of the number of states cutting taxes for the four major taxes (50) is greater than the total number of states cutting taxes (34) because some states, such as Iowa, Minnesota, New York, and Oregon, cut multiple classes of taxes. For example, Oregon enacted an EITC, will refund excess income tax revenues to both individuals and corporations, and will reduce and cap property taxes.
6. The sum of the states cutting personal income taxes (33) is greater than the number of states cutting personal income taxes (22) because some states enacted multiple cuts to their personal income tax. For example, Massachusetts enacted an EITC, doubled its dependent child deduction, and increased exemptions. Thus, Massachusetts enacted three separate tax actions that will reduce the personal income tax burden.
7. The Massachusetts and Oregon credits are 10% and 5% of the federal credit, respectively. Indiana enacted a $12,000 earned income tax deduction—not a credit—for low-income taxpayers with dependent children.
8. Colorado has a constitutional amendment to limit spending growth and refund surplus revenue. Ohio's refund is based on the size of the state's budget surplus and legislative discretion on how to use that surplus. Oregon has a "2% refund kicker" statute that refunds tax revenue that was over the projected biennial total.
9. California's conformity to federal capital gains for homeowners and IRA changes will affect its personal income tax revenue. Its conformity to federal S Corporation and research and development credit changes will affect the state's corporate tax revenue.
10. Although Vermont created a new state property tax and increased other state taxes, the revenue raised from these taxes will be more than offset by decreases in local property taxes. These actions result in a shift of primary responsibility for funding public schools, from localities to the state. Thus, classifying Vermont's tax actions as only increases is a little misleading.
11. The New York school property tax relief plan (STAR) is not a state tax cut, as the school property tax is not a state tax, but a local school district tax. The STAR plan raises exemptions for property owners against their school property tax. This will reduce property tax revenue collected by local school districts, not the state. The state will make up the revenue lost by localities, so the STAR plan may just as well be considered an increase in state expenditures as a cut in school property taxes.
12. The projected revenue loss for localities is if local governments do not use their authority under the referendum to increase taxes. According to an explanatory statement of the ballot measure by Washington's Office of the Secretary of State, under prior law (before the referendum passed) taxing districts were "limited to levying, in any one year, no more than 106% of the total regular property taxes levied in the highest of the three most recent years in which the taxes were levied." With the passage of Referendum Bill 47, the new law will limit the levy to the most recent 12 month inflation rate published by the federal Department of Commerce, and never more than 106%. A taxing district may, by a special majority, "establish a different limitation upon finding a 'substantial need,' but could never set a limit more than 106%." As under the prior law, a taxing district can still exceed its levy limit by obtaining voter approval of a specific proposition.
13. *State Tax Notes* Vol. 12, No. 22, June 2, 1997.
14. In September, Governor Symington resigned after he was found guilty on seven felony counts. Since Arizona does not have a Lieutenant Governor, Secretary of State Jane Dee Hull (R) became governor. The next election for governor is November 1998. Hull is expected to run.
15. Corina Eckl and Arturo Perez. *State Budget Actions*, 1997. (NCSL: Denver)
16. The New York State fiscal year begins April 1. It is the only state that has a fiscal year that begins before July 1. Alabama and Michigan start their fiscal years on October 1 and Texas starts its fiscal year September 1.
17. See *State Tax Notes*, Vol. 13, No. 3, July 21, 1997 for details.
18. Former Governor William Weld (R) left office in July to pursue the Ambassadorship to Mexico.
19. *The 1997-98 Budget: Fiscal Review and Analysis*, Office of the State Comptroller, Albany, NY (September, 1997).

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The Nelson A. Rockefeller Institute of Government
State University of New York
411 State Street
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